In the Supreme Court
OF THE
United States

OCTOBER TERM, 1962

No. 239

THE FARMERS UNION CORPORATION,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI
to the United States Court of Appeals
for the Ninth Circuit

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PETITION FOR A WRIT OF CERTIORARI
to the United States Court of Appeals for the Ninth Circuit

The petitioner prays that a Writ of Certiorari issue to review the judgment of the United States Court of Appeals for the Ninth Circuit, entered March 8, 1962, in the above-entitled proceeding, affirming the decision of the Tax Court of the United States relating to petitioner's income tax liability for the calendar years 1951, 1952 and 1953.

OPINIONS BELOW

The case was initiated in the Tax Court of the United States. The opinion of the Tax Court was contained in a memorandum decision and is not reported in the official Tax Court reports, but is printed in full in the printed transcript of record, pages 254 to 295. The opinion of the U. S. Court of Appeals for the Ninth Circuit is reported in 300 F(2d) 197, and is set forth in full in Appendix A hereto.

JURISDICTION

1. The judgment of the U. S. Court of Appeals sought to be reviewed was dated and entered March 8, 1962 (R. 308) (Appendix A hereto).

2. A petition for rehearing was duly filed with the said Court of Appeals on April 5, 1962, and was denied April 10, 1962 (R. 314).

3. Review by this Court is sought pursuant to authorization contained in Section 7482 of the Internal Revenue Code of 1954 (26 USC Section 7482), and Section 1254(1) of the Judicial Code as amended (28 USC 1254(1)).

QUESTIONS PRESENTED

In the year 1951 the petitioner taxpayer exchanged certain of its assets for 8000 shares of its outstanding capital stock. The petitioner taxpayer claimed a loss measured by the difference between the cost of the as-

sets exchanged and the fair market value of the 8000 shares of capital stock received by it in the exchange transaction. The Tax Court held that the exchange transaction should be treated as a partial liquidating distribution of assets in kind by the taxpayer corporation to the stockholders who exchanged their stock therefor, and the Tax Court then concluded that no loss was allowable upon such a partial liquidation of the corporation.

The Tax Court held that the transaction should be treated as a distribution in kind in partial liquidation of the corporation within the meaning of Sections 115(c) and 115(i) of the Internal Revenue Code of 1939 relating to the taxability against the stockholders of amounts received by them as distributions in partial or complete liquidation of the corporation, and rejected the taxpayer's claim that the results of the transaction in so far as the determination of gain or loss to the corporation was concerned should be determined under Section 111 and 112 of said Code, relating to the computation of gain or loss on sales or exchanges of property. The Court of Appeals sustained the decision of the Tax Court.

The questions presented are (1) whether under the Internal Revenue Code of 1939 an exchange by a corporation of part of its assets for shares of its own capital stock can be treated as a partial liquidating distribution under Section 115(c) and Section 115(i) of said Code, or whether such a transaction must be given whatever effect is attributable thereto for tax purposes under Section 112 of said Code; and (2)

whether a contraction of business and a formal reduction of stated capital of a corporation continuing in business, constitutes a partial liquidation of the corporation under Section 115(i) of the Internal Revenue Code of 1939.

STATUTES AND REGULATIONS INVOLVED

Sections 111 and 112, and Sections 115(c) and 115(i) of the Internal Revenue Code of 1939, and regulations thereunder. The pertinent text of these statutes and all applicable regulations are set forth in Appendix B of this petition.

STATEMENT OF THE CASE

The Commissioner of Internal Revenue proposed a substantial deficiency of income taxes against the petitioner taxpayer for the calendar years 1951, 1952 and 1953. The petitioner appealed to the Tax Court of the United States, contending that it was not liable for this tax and that the Commissioner erred in the determination of the deficiencies (Petition to Tax Court and Respondent's Answer to Petition (R. 5 to 11)). After the Tax Court opinion and decision (R. 254 to 299) sustaining the Commissioner, the petitioner appealed to the U. S. Court of Appeals for the 9th Circuit (Petitioner's Petition for Review, R. 300). The Appellate Court sustained the Tax Court (R. 308; Opinion attached hereto as Appendix A). Petitioner's petition for rehearing filed on April 5, 1962 was de-

nied on April 10, 1962 (R. 314). The petitioner now asks this Court to review the decisions of the Courts below.

In 1951 the petitioner corporation adopted a plan whereby it extended a written offer to all of its stockholders to exchange certain of its assets used in a hardware business which it was conducting, for 8000 shares of its outstanding capital stock, and for each share of stock surrendered, each person entering into the transaction would receive a 1/8000 interest in the transferred assets (R. 262-263, 288, 289). Pursuant to the plan, in 1951 some seven stockholders out of the 134 stockholders of the company exchanged 8000 shares of the capital stock of the company owned by them for the specified assets of the corporation (R. 266). The petitioner corporation continued in business with the assets which it retained. The 8000 shares of stock received by the company were held as treasury stock and have never been formally cancelled or retired. In February, 1952 the corporation reduced the stated value of its capital by an amount equal to the par value of the 8000 shares but did not cancel or retire the said 8000 shares.

The petitioner corporation claimed as a deductible loss as the result of the exchange an amount of $226,349.84 (R. 278), which produced a net loss for the taxpayer for the year 1951 which it used as a net operating loss carryover into the years 1952 and 1953 (R. 276). The Commissioner of Internal Revenue denied the loss claimed in 1951 on the exchange transaction on the ground that the transaction was a distribution

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in partial liquidation under Section 115(c) of the Internal Revenue Code of 1939, in redemption of the stock received by the corporation in the exchange, and that no deductible loss was allowable under the Internal Revenue Code upon such a transaction (R. 257). The Tax Court in its opinion sustained the Commissioner's contention (R. 280 to 293), and the Appellate Court sustained the Tax Court.

JURISDICTION OF COURT OF FIRST INSTANCE

Jurisdiction was conferred upon the Tax Court of the United States by Section 272(a) of the Internal Revenue Code of 1939 (Title 26 U.S.C. Section 272 (a), now Section 6213(a)), and by Section 6213(a) of the Internal Revenue Code of 1954 (Title 26 U.S.C. Section 6213(a)). The Commissioner's deficiency notice was dated June 20, 1957 (R. 5, para. 2, admitted in Answer, R. 8). The petition to the Tax Court was filed within 90 days thereafter on September 17, 1957 (R. 3).

Jurisdiction was conferred upon the U. S. Court of Appeals for the 9th Circuit by Sections 1141 and 1142 of said Internal Revenue Code (Title 26 U.S.C. Sections 1141 and 1142, now Sections 7482 and 7483), and Sections 7482 and 7483 of the Internal Revenue Code of 1954 (Title 26 U.S.C. Sections 7482 and 7483). The decision of the Tax Court was entered October 25, 1960 and petitioner filed his petition for review within three months thereafter, on January 19, 1961 (R. 3-4).

REASONS RELIED UPON FOR ALLOWANCE OF THE WRIT

1. In deciding that Sections 115(c) and 115(i) relating to the taxability of liquidating distributions received by a stockholder of the corporation was applicable in the determination of gain or loss realized by the corporation upon its exchange of some of its assets for shares of its own capital stock, the decisions of the Courts below are in direct conflict with the admonition of this Court in the case of *Commissioner v. Bedford's Estate*, 325 U. S. 283, to the effect that "the definition of a partial liquidation is specifically limited to use in Section 115. To attempt to carry it over to Section 112 would distort its purpose."

2. The said decisions of the Courts below in holding that Section 115 and not Section 112 is applicable to determination of gain or loss on an exchange by a corporation of some of its assets for some of its stock, are also in conflict with the decision of the Court of Appeals for the 5th Circuit in the case of *Dorsey v. Commissioner*, and with the decision of the Court of Appeals for the 5th Circuit in the case of *Hammond Iron Company v. Commissioner*, 122 F(2d) 4, which held that in transactions where a corporation exchanges property for its own capital stock, the transaction should be regarded as a sale of the property and not as a purchase of the stock, and consequently gain or loss should be determined under Sections 111 and 112, which relate to the determination of gain or loss on the sale or exchange of property. In the *Dorsey v. Commissioner* case, supra, the corpora-

tion sold a building that housed its plant, and took back a lease. It received cash and 1000 shares of its own stock as consideration for the transfer. After the transaction the purchasers of the building still continued to hold considerable stock in the corporation. The taxpayer contended that no gain could be realized by a corporation from the purchase or sale of its own stock, and, furthermore, that the transaction was a distribution to stockholders of capital falling under Section 115. The Court in rejecting the taxpayer's contention pointed out that the stock was put in Treasury and the transaction was an exchange of property for stock and was not a liquidating distribution. The Court concluded "that gain or loss arising in such an exchange of property of the corporation for its own stock is realizable. The later and better considered decisions, have held, even before the change of the regulations (*Walville Lumber Co. v. Commissioner* (CCA), 35 F(2d) 445; *Spear & Co. v. Heiner* (D.C.), 54 F(2d) 134, 135; *Commissioner v. Boca Ceiga Development Co.* (CCA), 66 F(2d) 1004)." The Court also said, "It is not the purchase of the stock but the sale of the real estate that is regarded."

3. The said decision of the Court below that the "formal reduction of stated capital" and "a contraction of the business" being carried on at the time of the exchange of assets by the corporation for shares of its own capital stock, constitute a partial liquidation within the meaning of Section 115(i) of the Internal Revenue Code of 1939, is an important question of law which has not been decided by the Court but should be settled by this Court.

CONCLUSION

Petitioner respectfully submits that the Court below erred in its decisions on the question presented herein, and therefore, for the reasons and on the grounds herein stated, petitioner respectfully requests that this Court grant this petition and issue its writ of certiorari.

Dated, San Mateo, California,
July 5, 1962.

Respectfully submitted,

RALPH A. YEO,
Counsel for Petitioner.

(Appendices A and B Follow)

Appendix A

United States Court of Appeals
for the Ninth District

THE FARMERS UNION CORPORATION,
Appellant,
vs.
COMMISSIONER OF INTERNAL REVENUE,
Appellee.

No. 17,352
March 8, 1962

On a Petition for a review of a decision of the Tax Court of the United States

Before: HAMLIN, KOELSCH and DUNIWAY, Circuit Judges

DUNIWAY, Circuit Judge:

In 1951, the Farmers Union Corporation operated a retail hardware business and also had substantial real estate holdings in San Jose, California. It desired to get out of the retail business, and transferred the inventory and related assets constituting that business to seven of its 134 shareholders, receiving in return 8000 of its 20,000 shares of stock. In its tax returns for 1951 it treated the transaction as a sale of inventory, claiming that it incurred a loss of $226,349.84, and reported a total loss of $246,952.11, $217,527.20 of which was attributed to this transaction. In its

1952 and 1953 returns, it used $16,544.54 and $26,982.20, as net loss carry-over deductions, pursuant to §122(b)(2)(B) of the Internal Revenue Code. (All references are to the Internal Revenue Code of 1939, unless otherwise noted.) It deducted as business expenses $450 in 1951 and $1,650.50 in 1952, paid for legal, escrow and accounting fees incurred in the claimed sale. The Commissioner, asserting deficiencies for each year, disallowed the claimed losses for 1951, 1952 and 1953, on the grounds that the transaction was a partial liquidation and not a sale, and therefore no "loss" could be recognized. (IRC §115 (c) and (i) Treasury Regulations 111, Sec. 29.22(a)-20.) and disallowed the claimed deductions for legal, escrow, and accounting expenses. The Tax Court sustained the Commissioner, and the Farmers Union appeals under 26 U.S.C. §7482 (1954 Internal Revenue Code).

Since 1945 the taxpayer had been trying to sell its merchandising business and restrict itself to operating its real properties. Its president sought out prospective buyers, and there was testimony that there were many offers, none resulting in sale. In 1950 the board of directors proposed dividing the taxpayer into two corporations, with shares in the new corporation distributed on a one-to-one basis to the taxpayer's shareholders. The shareholders approved the plan in November, 1950, but it was dropped. In May, 1951, however, the board adopted a resolution offering to all of the stockholders an opportunity to exchange 8000 shares of the taxpayer's stock for all of the assets

in the merchandising business, subject to designated liabilities. The plan, among other things, provided that the taxpayer would give to the transferees a twenty-year lease of the ground floor of the building where the store was located, at an annual rent of $18,000. The stockholders approved the plan at a special meeting on June 7, 1951, and an escrow agent was designated to receive stock certificates from those who elected to surrender stock under the plan. Most stockholders did not elect to participate, but by October 1, 1951 a group of seven had agreed to do so. The hardware assets were not transferred until the seven had formed a partnership to carry on the merchandising business. On August 16, 1951, the 8000 shares were in escrow but had not yet been surrendered to the corporation. On that date the directors resolved to reduce the taxpayer's stated capital by the amount of the par value of those shares, from $200,000 to $120,000, and on February 13, 1952, after the shares were surrendered, the stockholders at their annual meeting approved the reduction.

The Internal Revenue Code and regulations provide that "no gain or loss is realized by a corporation from the mere distribution of its assets in kind in partial or complete liquidation . . ." (Treasury Regulations 111, §29.22(a)-20), and define partial liquidation as a "distribution by a corporation in complete cancellation or redemption of a part of its stock . . ." (Internal Revenue Code, §115(i)). But where the corporation disposes of property, other than cash, in return for shares of its own capital stock, the transac-

tion may be a sale or exchange, taxable under §111 of the Internal Revenue Code, rather than a capital transaction, depending upon "the real nature of the transaction, which is to be ascertained from all its facts and circumstances." (Treasury Regulations 111, §29.22(a)-15; see 7 Mertens, Law of Federal Income Taxation, §38.29). The Regulations specify the following test: (Treasury Regulations 111, Sec. 29.22 (a)-15)

> "[I]f a corporation deals in its own shares as it might in the shares of another corporation, the resulting gain or loss is to be computed in the same manner as though the corporation were dealing in the shares of another. So also if the corporation receives its own stock as consideration upon the sale of property by it, or in satisfaction of indebtedness to it, the gain or loss resulting is to be computed in the same manner as though the payment had been made in any other property. Any gain derived from such transactions is subject to tax, and any loss sustained is allowable as a deduction where permitted by the provisions of the Internal Revenue Code."

In sum, if the corporation and the shareholder are dealing at arm's length and the circumstances show that the corporation regards the acquired stock as consideration for a sale, as it would if it acquired money or any other property, there is a taxable sale or exchange. (See Commissioner v. Boca Ceiga Development Co., 3 Cir., 1933, 66 F2d 1004; Dorsey Co. v. Commissioner, 5 Cir., 1935, 76 F2d 339; Hammond Iron Co. v. Commissioner, 5 Cir., 1941, 122 F2d 4;

Commissioner, v. S. A. Woods Mach. Co., 1st Cir., 1932, 57 F2d 635). But if the facts show the corporation is dealing with the shareholders primarily as stockholders—as participants in the common business enterprise—there is a capital transaction. (See Dill Mfg. Co. v. Commr., 39 B.T.A. 1023 (1939); Lucius Pitkin, Inc. v. Commissioners, 13 T.C. 547 (1949).)

We think that the Tax Court's finding that there was a partial liquidation, rather than a sale, is amply supported by the evidence. There was none of the care that ordinary businessmen usually show in bargaining. Before the stockholders' special meeting on June 7, 1951, the directors did attach to the notice of the meeting a statement showing the assets and liabilities to be transferred and those to be retained, but the resolution adopted only listed the categories of assets and types of liabilities to be transferred, and the printed "election form", by signing which a shareholder could elect to surrender one or more of his shares, added no additional information. The bill of sale eventually delivered to the partnership was as vague as the resolution, and no value was stated as the total value or per share value of the 8000 shares of stock. Moreover, much in the transaction suggests a re-arranging of the taxpayer's business enterprise. Although the Board of Directors referred to the plan at some times as a "partial liquidation" and at other times as a "sale", the resolution adopted by the shareholders on June 7, 1951 stated that the purpose of the plan was "to effect a division and segregation of the operation, management and maintenance of the real

properties of the corporation from the ownership, operation, management and control of the merchandising business of the corporation". The plan provided for a twenty-year lease, and the transfer of the business was not made until the seven shareholders had formed a partnership. The taxpayer's two controlling shareholders, Benson and McEnery, who before the transaction had 75.4% of the taxpayer's stock, retained their control of the taxpayer with 64%, and controlled the partnership by surrendering 7,507 of the 8000 shares. The partnership agreement provided that interests in the partnership shall be according to the contributions of the shareholders. The formal reduction of stated capital is consistent with partial liquidation, but not with the ordinary purchase of the shares. While it is true that the actions of a corporation after acquisition are not necessarily determinative as to the character of the transaction, (*cf* Golden State Theatre & Realty Corporation v. Commissioner, 9 Cir., 1942, 125 F2d 641, Allyne-Zerk Co. v. Commissioner, 6 Cir., 1936, 83 F2d 525) they are relevant. (See Dorsey v. Commissioner, *supra*, 5 Cir., 1935, 76 F2d 339.) In the principal case they show that the taxpayer envisioned not only a contraction of the business at the time being carried on, but also a contraction of the corporate enterprise.

There was also evidence suggesting a sale, but it is far from being enough to make the Tax Court's finding "clearly erroneous".

In short, we agree with the Tax Court that the "real nature of the transaction" (Reg. 111 §22.22(a)-15) was a partial liquidation.

The Tax Court properly sustained the Commissioner's disallowance of the claimed deductions for legal, escrow, and accounting expenses incurred in effecting the transaction. Expenses incurred for the purpose of changing the corporate structure for the benefit of future operations are not ordinary and necessary business expenses under §23(a)(1)(A) of the Code. (Motion Picture Capital Corporation v. Commissioner, 2d Cir., 1936, 80 F2d 872; Missouri-Kansas Pipe Line Co., 3rd Cir., 1945, 148 F2d 460; Mills Estate, Inc. v. Commissioner, 2d Cir., 1953, 206 F2d 244). This is not to say that expenses incurred in carrying out a partial liquidation are never ordinary and necessary business expenses (see Mills Estate, Inc. v. Commissioner, *supra*, 1953, 206 F2d 244; Standard Linen Service, Inc., 33 T.C. 1, 7 (1959)), but the taxpayer has not sustained its burden, for it has conceded both in the Tax Court and on this appeal that the deductibility of the expenses depends solely on whether there was a partial liquidation or sale.

The decision of the Tax Court is *affirmed*.

(Endorsed) Opinion Filed March 8, 1962.

Frank H. Schmid, Clerk.

United States Court of Appeals
for the Ninth District

THE FARMERS UNION CORPORATION, *Petitioner,* vs. COMMISSIONER OF INTERNAL REVENUE, *Respondent.*	No. 17352 Judgment

JUDGMENT

Upon Petition to Review a Decision of The Tax Court of the United States

This Cause came on to be heard on the Transcript of the Record from The Tax Court of the United States, and was duly submitted.

On Consideration Whereof, it is now here ordered and adjudged by this Court, that the Decision of the said Tax Court of the United States in this Cause be, and hereby is affirmed.

Filed and entered March 8, 1962.

Appendix B

INTERNAL REVENUE CODE OF 1939

Section 111—Computation of Gain or Loss

"The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis . . . for determining gain, and the loss shall be the excess of the adjusted basis . . . over the amount realized."

Regulation 111, Section 29.111-1

"Except as otherwise provided, the Internal Revenue Code regards as income or as loss sustained, the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or extent."

Section 115—Distributions by Corporations

(c) *Distributions in Liquidation*

"Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation of a corporation shall be treated as in part or full payment in exchange for the stock." The remainder of this section applicable in determining whether such distributions are out of capital or earnings.

Section 115—Distributions by Corporations

(i) *Definition of Partial Liquidation*

"As used in this section the term 'amounts distributed in partial liquidation' means a distribu-

tion by a corporation in complete cancellation or redemption of a part of its stock, or one of a series of distributions in complete cancellation or redemption of all or a portion of its stock."

Section 29.22(a)-20, Regulation 111—Gross Income of Corporation in Liquidation

"When a corporation is dissolved, . . . Any sales of property by them are to be treated as if made by the corporation for the purpose of ascertaining the gain or loss. No gain or loss is realized by a corporation from the mere distribution of its assets in kind in partial or complete liquidation, however they may have appreciated or depreciated in value since their acquisition."

Section 29.22(a)-15—Acquisition or Disposition by a Corporation of Its Own Capital Stock.

"Whether the acquisition or disposition by a corporation of shares of its own capital stock gives rise to taxable gain or deductible loss depends upon the real nature of the transaction, which is to be ascertained from all its facts and circumstances."

. . . .

"However, if a corporation deals in its own shares as it might in the shares of another corporation, the resulting gain or loss is to be computed in the same manner as though the corporation were dealing in the shares of another. So also if the corporation receives its own stock as consideration upon the sale of property by it, or in satisfaction of indebtedness to it, the gain or loss resulting is to be computed in the same manner as though the payment had been made in any

other property. Any gain derived from such transactions is subject to tax, and any loss sustained is allowable as a deduction where permitted by the provisions of the Internal Revenue Code."

Section 122(a). Definition of Net Operating Loss.

As used in this section, the term "net operating loss" means the excess of the deductions allowed by this chapter over the gross income, with the exceptions, additions, and limitations provided in subsection (d).

Section 122(d)-5.

Deductions otherwise allowed by law not attributable to operation of a trade or business regularly carried on by the taxpayer shall (in the case of a taxpayer other than a corporation) be allowed only to the extent of the amount of gross income not derived from such trade or business.

California Corporations Code

"1700. A Corporation may redeem any or all shares which are redeemable at its option by (a) giving notice of redemption, and (b) payment or deposit of the redemption price of the shares as provided in its articles . . ."

"1706. A Corporation may *purchase*, out of stated capital or out of any surplus, shares issued by it, . . . in any of the following cases:

(a) To collect or compromise in good faith a debt, claim, or controversy with any shareholder.

(b) To eliminate fractional shares.

(c) To redeem or purchase shares subject to redemption at prices not exceeding the redemption price thereof.

(d) From any shareholder who by reason of dissent from any proposed corporate action is entitled . . . to be paid the fair market value of his shares.

(e) From one who as an employee other than as an officer or director has purchased the shares from the corporation under an agreement reserving to the corporation the option to repurchase the shares."

"1710. When a corporation acquires its shares out of stated capital, under Section 1706, such shares are restricted to the status of authorized but unissued shares, and the stated capital may be reduced by resolution of the Board of Directors by the amount of stated capital attributable to such shares."

"1904. A reduction of stated capital may be authorized by a resolution of the Board of Directors approved by the future or written consent of the holders of a majority of outstanding shares . . ."